

Internal Revenue Service

Department of the Treasury
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PLR-138321-09

Date:

November 25, 2009

Legend

Distributing =

Controlled =

Controlled Subsidiary =

State X =

Business 1 =

Business 2 =

Shareholders =

Exchanging Shareholders =

Shareholder 1 =

aa =

Dear :

We respond to your August 17, 2009 request for rulings regarding certain federal income tax consequences of a proposed transaction. The information submitted in that request and in subsequent correspondences dated October 7, October 8, October 14, November 4, and November 17, 2009, is summarized below.

The rulings contained in this letter are based on facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

Moreover, no information provided by the taxpayer has been reviewed and no determination has been made regarding whether the transaction: (i) satisfies the business purpose requirement of § 1.355-2(b) of the Treasury Regulations; (ii) is used principally as a device for the distribution of the earnings and profits of the distributing corporation (“Distributing”) or the controlled corporation (“Controlled”) or both (see § 355(a)(1)(B) of the Internal Revenue Code and § 1.355-2(d)); or (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest in Distributing or Controlled (see § 355(e)(2)(A)(ii) and § 1.355-7).

Summary of Facts

Distributing, a State X corporation, is treated as an S corporation for federal income tax purposes and is engaged directly in Business 1. Distributing has aa outstanding shares of common stock owned by the shareholders (the “Shareholders”).

Distributing owns all the stock of Controlled, a State X corporation that has aa outstanding shares of Class B common stock. Shares of Class A preferred stock have been authorized, but no such stock has been issued. Controlled is a qualified subchapter S subsidiary (a “QSub”) for federal income tax purposes. Controlled and its wholly owned QSub, Controlled Subsidiary, are engaged in Business 2.

The financial information submitted by Distributing and Controlled indicates that each of Business 1 and Business 2 has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the last five years.

Distributing has proposed the following transaction in order to protect Business 1 from the risk of Business 2, to provide incentives to retain key employees of Controlled by increasing their equity interest in Controlled, and to create a capital structure that will allow key employees to have voting control of Controlled after the death of the majority shareholder.

Proposed Transaction

In order to achieve these purposes, Distributing will distribute all the stock of Controlled in a non-pro rata distribution (the "Distribution") pursuant to which certain of the Shareholders (the "Exchanging Shareholders") will receive Controlled stock in exchange for some or all of their Distributing stock.

Representations

The taxpayer has made the following representations in connection with the proposed transaction:

- (a) The fair market value of Controlled stock and other consideration to be received by each shareholder of Distributing will be approximately equal to the fair market value of the stock of Distributing surrendered by the shareholders in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a Distributing shareholder.
- (c) The 5 years of financial information submitted on behalf of Distributing with respect to Business 1 is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) The 5 years of financial information submitted on behalf of Controlled with respect to Business 2 is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (e) Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees, except that an Exchanging Shareholder (Shareholder 1) will continue to serve as President and Chief Executive Officer of both corporations, and several other employees will be shared for reasons of efficiency and cost-effectiveness. All shared employees (including Shareholder 1) will be paid the fair market value of their services by each corporation.
- (f) Neither Business 1 nor Business 2 nor control of an entity conducting either business will have been acquired during the five-year period ending on the date of the Distribution in a transaction in which gain or loss was recognized (or treated as recognized) in whole or in part, except for transactions that expanded Business 1 or Business 2.
- (g) The distribution of the stock of Controlled is carried out for the following business purposes: (1) reducing the risk that Distributing's assets would be subject to environmental or clean-up claims against Controlled; and (2) creating a capital structure

for Controlled that gives its key employees a greater equity participation and greater voting control, which will enhance the future success of Controlled. The distribution of the stock of Controlled is motivated, in whole or substantial part, by one or more of these corporate business purposes.

(h) The transaction is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.

(i) The total adjusted bases and the fair market value of the assets deemed transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed (within the meaning of § 357(d)) by Controlled plus any liabilities to which the transferred assets are subject.

(j) The liabilities assumed (within the meaning of § 357(d)) in the transaction and the liabilities to which the assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.

(k) The fair market value of the assets of Controlled will exceed the amount of its liabilities immediately after the exchange.

(l) The aggregate fair market value of the assets deemed transferred to Controlled in the Contribution will equal or exceed the aggregate adjusted basis of these assets.

(m) The income tax liability for the taxable year in which investment credit property (including any building to which § 47(d) applies) is transferred will be adjusted pursuant to § 50(a)(1) or § 50(a)(2) (or § 47, as in effect before amendment by Public Law 101-508, Title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of the property.

(n) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.

(o) No intercorporate debt will exist between Distributing and Controlled or Controlled Subsidiary at the time of, or subsequent to, the distribution of the stock of Controlled.

(p) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(q) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total

combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution or (ii) attributable to distributions on Distributing stock or securities that were acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(r) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled or Controlled Subsidiary will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

(s) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).

(t) There is no acquisition of stock of Distributing or Controlled or Controlled Subsidiary (including any predecessor or successor of any such corporation) that is part of a plan or series of related transactions (within the meaning of § 1.355-7) that includes the distribution of the stock of Controlled.

(u) Immediately after the transaction (as defined in § 355(g)(4)), neither Distributing nor Controlled will be a disqualified investment corporation (within the meaning of § 355(g)(2)).

(v) Distributing is an S corporation (within the meaning of § 1361(a)), and Controlled and Controlled Subsidiary are QSubs that are disregarded entities for federal income tax purposes.

(w) Immediately after the Distribution, Controlled will be eligible to elect S corporation status pursuant to § 1362(a), effective immediately after the Distribution.

(x) Controlled will elect to be treated as an S corporation effective immediately after the Distribution (see § 1.1361-3(a)(4)).

(y) There is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

(z) Controlled will elect to treat Controlled Subsidiary as a qualified subchapter S subsidiary on the first available date after the distribution and there is no plan or intent to revoke or otherwise terminate the qualified subchapter S subsidiary election for Controlled Subsidiary.

(aa) None of the persons holding stock, membership interests, or any equity interest in either Distributing or Controlled is a nonresident alien individual, a foreign corporation, or a trust (except for trusts meeting the requirements of § 1361(c)(2)).

Rulings

Based solely on the information submitted and the representations made, we rule as follows:

- (1) The Distribution will cause a termination of Controlled's election to be a QSub because Controlled will cease to be a wholly-owned subsidiary of an S corporation. For federal tax purposes, the Distribution will be treated as if Controlled is a new corporation acquiring all the assets (and assuming all of the liabilities) of Controlled and Controlled Subsidiary in a deemed contribution (the "Contribution") from Distributing occurring immediately before the Distribution, and Distributing will be deemed to receive the voting stock of Controlled in exchange for the Contribution (§ 1.1361-5(b)(1)(i)).
- (2) The Contribution followed by the Distribution will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be a "party to a reorganization" within the meaning of § 368(b).
- (3) Distributing will recognize no gain or loss on the Contribution (§§ 361(a) and 357(a)).
- (4) Distributing will recognize no gain or loss on the Distribution (§ 361(c)(1)).
- (5) Controlled will recognize no gain or loss on the Contribution (§ 1032(a)).
- (6) The basis of each asset deemed received by Controlled from Distributing will be determined in accordance with §§ 362(b) and 362(e).
- (7) The holding period for each asset deemed received by Controlled from Distributing will include the period during which such asset was held by Distributing (§ 1223(2)).
- (8) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).
- (9) The Exchanging Shareholders will recognize no gain or loss on their receipt of Controlled stock solely in exchange for Distributing stock (§ 355(a)(1)).
- (10) The aggregate basis of the Controlled stock in the hands of the Exchanging Shareholders after the Distribution will, in each instance, equal the aggregate basis of the respective Distributing stock surrendered by the Exchanging Shareholders in exchange therefor (§ 358(a)(1)).

(11) The holding period of the Controlled stock received by the Exchanging Shareholders in the Distribution will include the holding period of the Distributing stock with respect to which it is received, provided that the Distributing stock is held as a capital asset in the hands of the Exchanging Shareholder on the date of the exchange (§ 1223(1)).

Caveats

Except as expressly provided herein, no opinion is expressed about the tax treatment of the transactions described above under other provisions of the Code or regulations, or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions not specifically covered by the above rulings. In particular, no opinion is expressed regarding: (i) whether the Distribution satisfies the business purpose requirement of § 1.355-2(b); (ii) whether the Distribution is used principally as a device for the distribution of earnings and profits of Distributing and Controlled or both (see § 355(a)(1)(B) and § 1.355-2(d)); or (iii) whether the Distribution is part of a plan (or series of related transactions) under § 355(e)(2)(A)(ii). Additionally, no opinion is expressed regarding issues relating to Controlled's subchapter S election.

Procedural Statements

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code provides that this private letter ruling may not be used or cited as precedent.

A copy of this letter must be attached to the federal income tax returns to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching to the return a statement that provides the date and control number (PLR-138321-09) of this ruling letter.

Pursuant to the power of attorney on file in this matter, a copy of this letter is being sent to your authorized representative.

Sincerely,

Lisa A. Fuller
Senior Counsel, Branch 1
Office of Associate Chief Counsel (Corporate)

cc: